CHAPTER 6
INFORMATION CONTROLS

Introduction

During this year's reporting cycle, the Commission held a hearing that addressed Beijing's employment of various measures to control information. Over the past year, the Chinese government modified the legal and regulatory framework for state and trade secrets, clarifying some components but leaving others vague enough to employ arbitrarily and flexibly. Chinese authorities recently demonstrated a willingness to use these laws and regulations in ways that raise concern about foreign firms' opportunity to conduct business in China. In addition, Chinese companies' continued use of U.S. markets to raise capital poses questions about the adequacy of U.S. regulatory standards. This section aims to address these emerging trends and concludes with an analysis of the implications for the United States.

State and Trade Secrets

China's "state secrets" regime dates back to the early days of the People's Republic of China. This subsection provides background information on the numerous laws, regulations, and policies that comprise this legal regime and explains new developments in 2010. Most notably, this includes amendments (passed in April) to the State Secrets Law and new regulations (issued in March) regarding trade secrets.

State Secrets Law

China's State Secrets Law, which underpins many of the country's information controls, has had three phases: initial regulations first issued in 1951; a 1988 overhaul; and substantial amendments in 2010.

1951 Regulations

In 1951, Chinese authorities passed the *Regulations on the Preservation of State Secrets*, which governed all information related to enumerated subject areas such as national defense and foreign relations. The law, however, also included catch-all provisions intended to cover "all State affairs not yet decided upon" and "all other State affairs that must be kept secret." Mitchell A. Silk, partner and head of the U.S.-China Group at Allen & Overy LLP, testified to the Commission that in practice, these legal qualifiers created an environment where "whatever was a 'State secret' was a state secret, and whatever was not a 'State secret' was potentially a state secret."[1]

1988 State Secrets Law

Within a decade of China's move toward opening and reform, the country's leadership recognized that greater accessibility of information would encourage higher rates of much-desired foreign investment, according to Mr. Silk.[2] To this end, the National People's Congress replaced the 1951 regulations with the *1988 Law of the People's Republic of China on Guarding State Secrets* (known colloquially as the "State Secrets Law"), which narrowed somewhat the categories of classified information. The law included other helpful developments, such as an explanation of classification levels and provisions for declassification. However, the law still contained ambiguous language and catch-all provisions, including restrictions on information related to "other matters that are classified as State secrets by the national State Secrets Bureau."* [3]

2010 Amendments

On April 29, 2010, China's National People's Congress revised the country's State Secrets Law. The changes, which took effect on October 1, 2010, included two notable developments. First, according to Mr. Silk, the amendments explicitly directed information technology firms to, among other things, "cooperate with public and national security authorities in the investigation of cases involving the disclosure of state secrets." He testified that "[t]his obligation extends to preventing the continued transmission of classified information." Network operators, furthermore, are charged with "providing details regarding the transmission of classified information to the authorities, with penalties imposed for any failure to comply."[4] According to Mr. Silk, however, these new provisions may not in practice induce much of a change: Most network operators and service providers are wholly or partially state owned and thus already by existing measures compelled to cooperate with authorities in state secrets-related investigations.[5]

Second, the law restructures guidelines on how to label and handle state secrets, including regulations for the declassification of state secret information. Information may now be deemed "Ordinary Secret" and "Confidential Secret," which confer classified status for ten years and 20 years, respectively, by authorized departments of the central, provincial, and city governments. Information may be designated "Top Secret," apparently valid for a period of 30 years, only by authorized departments of the central and provincial governments.[6] Author and columnist Gordon G. Chang testified to the Commission that Chinese authorities may not always observe these limits in practice, since:

> *Communist Party or government officials, to defend a prosecution for disclosure of a particular item of information, can always maintain they had previously extended the protection of that item before the general time limit had elapsed.*[7]

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*The national States Secrets Bureau, formally titled the National Administration for the Protection of State Secrets, is a State Council organ that takes "primary responsibility for the administration of the state secrets framework and the designation of state secrets . . . with the exception of the administration of military secrets." Human Rights in China, *State Secrets: China's Legal Labyrinth* (New York: 2007), p. 16.

Mr. Silk testified that "[t]he amendments do provide some welcome changes in classification ambiguities and treatment of classified information, but they fail to resolve significant lingering uncertainties." Problematically, the law still includes language that "does not provide any further clarity as to what matters will be considered State secrets, nor does it narrow the broad range of information that could be covered by the State Secrets Law." Mr. Silk concluded that "the law's ambiguity will allow for flexible enforcement that could be guided by China's prevailing political winds."[8] Mr. Chang raised the question of "whether the textual changes to the State Secrets Law have any significance." He assessed that "[i]n a society where neither the Communist Party nor the government respects the rule of law, the fast—and definitive—answer is 'no.'"[9]

Trade Secrets Provisions

On March 25, 2010, China's State Assets Supervision and Administration Commission, the body in charge of all central government-owned state enterprises, issued the *Tentative Provisions for the Protection of Trade Secrets by Centrally-Governed Enterprises*. According to Mr. Silk's testimony, these new regulations govern commercial secrets, which "may be considered a lesser version of State secrets, in that they concern the economic interests of [China] through its [state-owned enterprises]." The laws specifically address the 128 state-owned enterprises associated with the central government but will most likely inform the rules governing provincial- and other local government-owned firms across China.[10]

One analysis described the new provisions as "vague and extremely broad," citing their expansive definition. They reportedly cover two types of information:

- *Operational information*, such as "strategic plans, management methods, business models, ownership restructuring and [initial public offerings], merger, acquisition, restructuring, property transaction, financial information, investment and financing decisions, manufacturing, purchasing and sales strategy, resource storage, customer information, and tender and bid";[11] and
- *Technical information*, including "design, procedures, product formula, processing technology, manufacture method and know-how, etc."[12]

Other Relevant Regulations

Other laws and regulations continue to apply to China's state secrets regime. Four in particular bear mentioning.*

Criminal Law

Various amendments to China's Criminal Law further stipulate specific sanctions for violations of state secrets.[13] For example, article 111 penalizes "whoever steals, spies into, or unlawfully supplies state secrets or intelligence to an organ, organization, or individual

*A more complete account of relevant articles and their associated penalties is included in the written testimony of Mitchell A. Silk, available at *www.USCC.gov*.

outside the territory of China."[14] Article 282 punishes anyone who "unlawfully holds the documents, material, or other objects classified as 'strictly confidential' or 'confidential' State secrets and refuses to explain their sources and purposes."[15]

State Security Law

Similarly, two portions of China's State Security Law, Article 4 and Article 20, contribute to China's state secrets regime. Article 4 provides the basis for prosecuting those accused of endangering state security, including by "stealing, gathering, procuring, or illegally providing State secrets." Article 20 holds that "no organization may illegally hold any documents, information or other materials classified as State secrets."*[16]

1996 Interim Provisions on the Prohibition of Commercial Bribery

These provisions, which draw from China's Criminal Law and the Anti-Unfair Competition Law, add another dimension to China's state secrets laws. Specifically, the provisions apply to state secrets enforcement actions related to economic issues and penalize any improper benefits gained through improper means.[17]

1990 Measures for Implementing the Law on the Protection of State Secrets

This regulation provides for what one report summarized as "retroactive classification of information not already enumerated or classified as a state secret."[18]

Information on U.S.-listed Chinese Firms

Chinese companies increasingly seek to raise capital in U.S. markets. A Chinese firm listed on an American exchange for the first time in October 1992;† today, NASDAQ and the New York Stock Exchange combined list 88 Chinese companies.‡ The Securities and Exchange Commission, the U.S.'s primary enforcement agency, maintains an Office of International Corporate Finance charged with protecting U.S. investors by evaluating the completeness and accuracy of materials from Chinese and other foreign firms.§ That office's chief, Paul Dudek, testified to the Commission that his staff

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*Some evidence suggests that Chinese authorities have recently enforced these laws with more vigor and with a broad interpretation. For example, Rebecca MacKinnon testified to the Commission that "in 2008 arrests and indictments on charges of 'endangering state security'—the most common charge used in cases of political, religious, or ethnic dissent—more than doubled for the second time in three years." See U.S.-China Economic and Security Review Commission, *Hearing on China's Information Control Practices and the Implications for the United States*, written testimony of Rebecca MacKinnon, June 30, 2010.

†The firm in question was China Brilliance Automotive, a minivan manufacturer. It listed on the New York Stock Exchange. See Peter M. Friedman, "Risky Business: Can Faulty Country Risk Factors in the Prospectuses of U.S.- Listed Chinese Companies Raise Violations of Securities Law?" *Columbia Journal of Transnational Law* (2005–2006): 245.

‡A list of these companies can be found on the Bank of New York Mellon Depository Receipts Directory at *http://www.adrbnymellon.com/dr__directory.jsp*. Users must select "China" from the "Country" list and the desired exchange(s) from the "DR Exchange" list. Figures cited above are accurate as of October 8, 2010.

§The office is part of the Division of Corporate Finance, which "has primary responsibility for overseeing disclosures by issuers of securities." See U.S.-China Economic and Security Review Commission, *Hearing on China's Information Control Practices and the Implications for the United States*, written testimony of Paul Dudek, June 30, 2010. Mr. Dudek testified in a personal capacity.

must review "annual and other periodic reports" for approximately 950 foreign firms, including:

> *about a dozen large companies incorporated in China and several dozen smaller companies that are incorporated in a foreign country outside of China (typically the Cayman Islands) that conduct substantially all of their business operations in China. Some of these companies disclose substantial ownership by the Chinese government.* [19]

Disclosure laws and norms are intended to ensure the smooth operation of U.S. capital markets and serve as the Securities and Exchange Commission's most potent tool to determine the accuracy and completeness of information provided by companies listed on U.S. exchanges. The United States requires companies to disclose material information including assets, liabilities, operations, and executives to provide necessary transparency for U.S. markets.* These disclosure requirements ensure that potential investors can make informed decisions about whether to purchase a given security. According to testimony to the Commission by Peter M. Friedman, a New York-based lawyer, the Securities and Exchange Commission requires disclosure for numerous categories of risk, including "the lack of business history, adverse business experience, competitive factors, and certain types of transactions with insiders." These disclosures are intended, he said, to clarify the "most significant factors that make the offering speculative or risky." [20]

"Country risk" is one such category that has particular relevance for Chinese companies, given that nation's political and economic features. Mr. Dudek testified that, in addition to risks that may affect all foreign firms, such as changes in currency valuation:

> *companies from China typically address other factors as well, such as risks associated with state ownership, the increased role of the Chinese government in the Chinese economy, Chinese regulations restricting foreign ownership of a Chinese company in certain industries, and the less developed state of legal principles and the civil law structure governing business in China.* [21]

Given the implications of these risks, and the seriousness of numerous others that affect the business environment in China, questions remain about the adequacy of Chinese corporate disclosures. To this end, five trends in particular merit consideration: (1) the Chinese Communist Party's role in business; (2) other forms of state intervention in firms and markets; (3) the lack of legal recourse in cases of impropriety; (4) related-party transactions at large, state-owned enterprises; and (5) the opacity of firms' ownership structures. These factors apply to China's state-owned enterprises and, in some cases, private firms, as both now routinely seek U.S. capital from investors. Each factor is discussed below.

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*The Securities Act of 1933 holds that "material" information is that for which "there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." Subsequent case law has further clarified the standard. See U.S.-China Economic and Security Review Commission, *Hearing on China's Information Control Practices and the Implications for the United States*, written testimony of Peter M. Friedman, June 30, 2010.

Chinese Communist Party Involvement

The Chinese Communist Party maintains a robust role in Chinese business. This involvement is multidimensional, but firm control exercised over state-owned enterprise officials' promotions and transfers remains one of the central considerations from the standpoint of business autonomy. Dr. James V. Feinerman, professor at Georgetown Law School, testified that:

> *one remaining feature of the central planning system, a politically controlled personnel system, still governs government entities at all levels, including [state-owned enterprises]. China's central government and Communist Party committees have the ultimate authority over the selection, appointment, and dismissal of top managers of almost all large, strategic [state-owned enterprises] under the administration of the State Asset Supervision and Administration Commission. Managers rotate through a revolving door between enterprise and government posting as they move up the political ranks, in parallel with their rise within the Communist Party.*[22]

This practice appears to be institutionalized.[23] Tellingly, these frequent personnel shuffles can include transfers to and from government entities or between competitive state-owned enterprises. Dr. Feinerman cited the banking sector as one example, where "the top officials at China's financial sector regulatory agencies, the central bank, and the major state-owned banks are senior Chinese Communist Party members, whose appointments are often dictated by political considerations."[24] Moreover, he said, there is "virtually no disclosure of Communist Party involvement in the appointment process for managers, directors, and officers of [Chinese] enterprises, nor are the parallel positions of directors, officers, and managers within the Communist Party described in their biographies."[25]

Asked whether the Securities and Exchange Commission should require disclosure about the involvement of the Chinese Communist Party in the operations of a U.S.-listed Chinese firm, Mr. Dudek testified to the Commission that "that is something that I think should be explored. . . . [I]t clearly goes to not only the sort of business and experience with the company, but also the important relationships outside the company [that] should be disclosed as well." He noted that such a disclosure might not be appropriate in every case. Mr. Dudek further testified that the Chinese Communist Party is "not just another political party," but acknowledged that the Securities and Exchange Commission staff has never requested clarification about a U.S.-listed Chinese state-owned enterprise's disclosure on Communist Party involvement in a listed entity.[26] Mr. Dudek further stated that the Securities and Exchange Commission disclosure review processes are organized by industry and do not necessarily include staff with country-specific expertise.[27]

Other State Intervention in Firms and Markets

Chinese officials view large, state-owned enterprises as "quasi-governmental agencies" as opposed to "independent, profit-making commercial entities," according to Dr. Jing Leng, assistant professor of law at the University of Hong Kong.[28] China's state-owned enterprises, therefore, are subject to government directives regarding basic operations. The government can induce a state-owned enterprise to purchase materials or services from other state firms, regardless of price, quality, or availability. State-owned banks can be forced to issue questionable loans to serve domestic policy interests.

China's leadership has sometimes combined personnel shifts with broad market interventions severe enough to functionally rearrange an entire sector. Perhaps the most illustrative example of this practice came with a recent overhaul of China's telecommunications industry, undertaken to strengthen and streamline the field. After years of frequent adjustments, Chinese authorities merged six state-owned enterprises into three companies: China Mobile, China Telecom, and China Unicom. The head officials at these firms, Wang Jianzhou, Wang Xiaochu, and Chang Xiaobing, respectively, each have experience as a high-ranking executive at one of his competition's firms.[29] Richard McGregor described this series of moves as:

> *the equivalent of the [chief executive officer] of AT&T being moved without notice to head its domestic U.S. competitor, Verizon, with the Verizon chief being appointed to run Sprint, at a time when all three companies were locked in a bruising battle on pricing and industry standards.*[30]

Lack of Legal Recourse

Legal action against a U.S.-listed Chinese firm could be difficult or impossible to enforce. According to Dr. Feinerman, "Chinese courts are not subject to any treaty or convention obligating them to recognize judgments by courts in the [United States]."[31] The case of now-defunct First Natural, a mainland China-based, Hong Kong-listed seafood company, illustrates the difficulty in legally engaging entities in mainland China, even for regulators in Hong Kong. As of June 2008, First Natural had almost $270 million in net assets, according to the *South China Morning Post*. But by January 2009, Hong Kong's High Court declared the firm insolvent, and subsequent reports noted improper bookkeeping practices. The firm's Hong Kong investors, however, had no mechanisms by which to pursue legal action, given the absence of a joint rendition treaty between Hong Kong and the mainland.[32]

In the event of a similar scenario in the United States, any enforcement actions against a Chinese firm would require "extensive assistance" from a regulator within China because, according to Mr. Dudek, "the Securities and Exchange Commission's compulsory processes are not effective in foreign countries."[33] He went on to testify that the Securities and Exchange Commission has "very good relations . . . from an enforcement point of view with the [China Securities Regulatory Commission],"[34] China's main securities enforcement agency. Problematically, however, aside from its

role as a "disclosure watchdog," the China Securities Regulatory Commission is also charged with the sometimes conflicting role of promoting investment in the Chinese stock market.[35] This could conceivably limit cooperation in some contexts.

Related-party Transactions at Large, State-owned Enterprises

Financial obligations and relationships between large, state-owned enterprises and their associated "spin-off" firms can be exceedingly difficult to understand. Dr. Feinerman testified to the Commission that "the extent of related-party transactions as well as their full disclosure may prove problematic; in [China], such transactions are often numerous, complex, and inadequately disclosed."[36] According to Dr. Leng, state-owned enterprises sometimes "hive off the best businesses of an inefficient state giant and then repackage them into a new [subsidiary] company with stronger management to set up a listing entity, and finally sell shares of the new firm to the public." The new subsidiary may then engage in "unsecured business dealings" with the parent company (i.e., the unprofitable remains of the state-owned enterprise) in which the new entity is required to lend financial support to the parent firm.[37] For example, in 2004, purchasers of China Life's initial public offering filed a class action lawsuit against the company, claiming it failed to disclose a $652 million financial fraud perpetrated by its parent company.[38]

Asked about the Securities and Exchange Commission's view of such related-party transactions, Mr. Dudek testified that "[w]e don't make any judgments. We make sure that [transactions] are disclosed."[39] The voluntary nature of U.S. disclosure requirements further complicates matters, as the Securities and Exchange Commission does not have full access to company records.

Opacity of Ownership Structures

Exact information about the ownership of U.S.-listed Chinese firms remains difficult to discern. According to the testimony of Mr. Friedman:

> *[A]n analysis of the ownership structures of [certain U.S.-listed Chinese] companies raises some issues. The entities listed in the U.S. are usually offshore holding companies incorporated in the U.S. Cayman Islands or other domiciles outside of China, and the operating entities and assets are located in China. There is no easily searchable database or other resource to verify the onshore ownership structure of these companies. Nothing is usually disclosed in the prospectuses to indicate any government involvement, but it is difficult to know whether local or provincial governments play a role in the operation of these companies and the extent of that role.*[40]

Potential investors must have a complete understanding of a listed firm's ownership in order to assess whether major stakeholders in the company would necessarily act in the investor's best interests. Foreign government entities in particular may not always be willing or able to do so. In characterizing the risk posed by this

issue, Mr. Friedman testified that "[i]t is not necessarily a problem that local and provincial governments may be involved with these companies in some capacity, but such disclosure is lacking."[41] The key issue is transparency.

The five issues outlined above represent risks to U.S. investors. Some are unique to China. Despite these problems, country risk disclosures in the official filings of U.S.-listed Chinese companies are composed of "relatively formulaic statements" that have not materially changed in "content and language" since the first Chinese company listed on a U.S. exchange in 1992, according to Dr. Feinerman. He described these minimal changes, combined with an overall reduction of content in prospectuses, as "worrisome from [the] standpoint of disclosure of material information."[42] Dr. Feinerman concluded that:

> *there is a decided trend away from more disclosure about Chinese country risk. The language has changed very little over the past decade, while [China] has changed greatly. The boilerplate language found in the country risk section raises the question of whether Chinese enterprises disclose enough information to avoid potential liability under federal securities laws for material omissions or misrepresentations in that section.*[43]

This boilerplate language filed by Chinese companies appears to stem from the precedent-based nature of the Securities and Exchange Commission's disclosure requirements. Both Dr. Feinerman and Mr. Friedman testified to the Commission that companies preparing disclosure documents refer back to, and largely reproduce, previous disclosures made by listed firms in the same industry.[44]

Implications for the United States

China's handling and control of information present serious implications for the United States. First, China's state secrets laws are vague and designed to permit arbitrary enforcement, which could be used to forward political objectives. Mr. Chang testified that China's new State Secrets Law "directly affects every American business operating in China," given the possibility for unpredictable legal charges.[45] This observation appears to be borne out in the case of Xue Feng, an American geologist sentenced in July to eight years in prison in China for purchasing publicly available geological reports that Chinese authorities retroactively deemed to be state secrets.[46] Citing such enforcement actions, Mr. Chang noted that, in order to "obtain an advantage in commercial transactions . . . Beijing's weapon of choice, it now appears, is the State Secrets Law." Similarly, in the case of American automotive engineer Hu Zhicheng arrested in late 2008, Chinese authorities demonstrated the willingness to enforce trade secrets provisions for what Mr. Hu's wife called "punishment over a business dispute."[47]

Second, Chinese firms' recent disclosure practices in the United States indicate a lack of transparency about key issues. This manifests in several areas, including the use of boilerplate language throughout official company filings and a general reduction in coverage about specific Chinese "country risks." The Securities and

Exchange Commission reviews and clears the filings submitted by all firms before the documents can be reviewed by the public. However, questions remain about whether the U.S. enforcement regime is configured in such a way that would ensure sensitivity to unique country risks. Specifically, the Securities and Exchange Commission's Office of International Corporate Finance, according to testimony by Mr. Dudek, is arranged by industry sector. This means that experts charged with reviewing corporate information related to, for example, telecommunications companies, might examine documents for such companies from any country in the world that sought to list on a U.S. exchange. The absence of country expertise increases the risks that Chinese firms could, for example, submit prospectuses that do not fully disclose the role of the Chinese Communist Party in all aspects of personnel decisions at state-owned enterprises.

Finally, there is a potentially troubling nexus between China's state secrets regime and disclosures by U.S.-listed Chinese companies to U.S. regulatory bodies. According to Mr. Chang, China's "State Secrets Law can undermine American securities laws." A U.S.-listed Chinese firm could, for example, withhold information that should be disclosed to U.S. regulators for fear of resulting legal reprisals in China. Mr. Chang testified that companies bound by two conflicting sets of law, one foreign and one domestic, generally "comply with the law of their home jurisdiction and . . . violate the laws of others."[48] Finally, he noted that executives at:

> *larger state enterprises, the ones that actually list on American markets, . . . are appointed by the Communist Party. So it's very unlikely that they are going to anger their superiors at home by disclosing what they must under U.S. securities law and thereby . . . violate their own State Secrets Law.*[49]

Conclusions

- The Chinese government refined its state and trade secrets regime in 2010. This effort yielded some clarifications, but several laws and regulations still contain broad language that allows for ambiguous interpretation and arbitrary enforcement. In recent years, Chinese authorities have enforced these provisions on U.S. citizens doing business in China.
- For U.S.-listed Chinese firms, China's state secrets laws could conceivably conflict with U.S. disclosure requirements. If the firms defer to the Chinese laws, U.S. investments could be at increased risk.
- Official filings from U.S.-listed Chinese companies may not adequately disclose material information that relates specifically to China, such as the pervasiveness of Chinese Communist Party influence in the day-to-day operations of state-owned enterprises and their subsidiaries.